

GAO

**Report to the Honorable
Russell D. Feingold, U.S. Senate**

December 1998

DEFENSE TRADE

U.S. Contractors Employ Diverse Activities to Meet Offset Obligations



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National Security and
International Affairs Division

B-297767

December 18, 1998

The Honorable Russell D. Feingold
United States Senate

Dear Senator Feingold:

This report provides information you requested on the types of activities undertaken by U.S. contractors to meet offset obligations associated with the sale of defense equipment to various foreign governments. Offsets are the entire range of industrial and commercial benefits that are provided to foreign governments as inducements or conditions for the purchase of military goods and services. They include, for example, coproduction and subcontracting, technology transfers, in-country procurements, marketing and financial assistance, or joint ventures.

Our review examined offset transactions of six major U.S. defense contractors. We obtained and analyzed data for over 100 offset transactions on defense weapon system procurements by countries in the Middle East, Europe, and Asia. The transactions were primarily from ongoing or recently completed offset programs reflecting both high and low dollar procurements and tied to foreign military sales (FMS) contracts. Although the sample is not statistically valid, contractors have indicated that these transactions are representative of their offset activities.

Results in Brief

Companies undertake a broad array of activities to satisfy offset requirements. Under offset programs, U.S. contractors commonly award subcontracts for components and subsystems to firms in purchasing countries, and in a few cases, have made longer term commitments covering foreign firm participation in the event of future sales of weapon systems. This activity has been accompanied by technology transfers, for example, providing manufacturing technology needed to produce a component. Placing contracts overseas has resulted in the emergence of additional contractors that are qualified to participate in weapon system development and production. However, the long-term supplier relationships that develop may result in reduced business opportunities for some U.S. firms. Nonetheless, the value of the export sale, in the transactions examined, greatly exceeded the amount of work placed overseas. For procurements not directly related to weapon systems, U.S. prime contractors enlisted their major subcontractors, their suppliers, and other foreign entities to help meet offset obligations.

U.S. contractors also undertook a wide variety of activities that could be labeled business development. These activities are similar to those that an economic development ministry performs. Contractors provided technical assistance to foreign firms across a wide range of technologies and industries and assisted foreign firms in marketing their products in export markets using the expertise of the contractors' own organizations or consultants. In a few cases, U.S. contractors advocated a foreign firm's product to the Department of Defense (DOD) or suppliers. In isolated cases, offset transactions involved financial assistance to subsidize particular export sales. These transactions were limited to foreign markets and therefore did not involve improper incentive payments under U.S. law. U.S. contractors also facilitated or established joint ventures with firms in the offset country. While a country's economic development ministry might perform similar activities, the offset program allowed the country, or firms in the country, to leverage the expertise and know-how of major U.S. multi-national firms.

Background

The ever increasing costliness of defense equipment, the limited defense budgets, the concerns about employment levels, and the importance of industrial competitiveness in a global economy have led governments to leverage their imports of major weapon systems so as to yield benefits for their domestic economies. Offsets are one way to achieve these benefits. Such programs are often an essential part of a weapons procurement and allow the purchasing government to build public support for large expenditures of public funds. It is difficult to accurately measure the impact of offsets on the overall U.S. economy and on specific industry sectors.¹

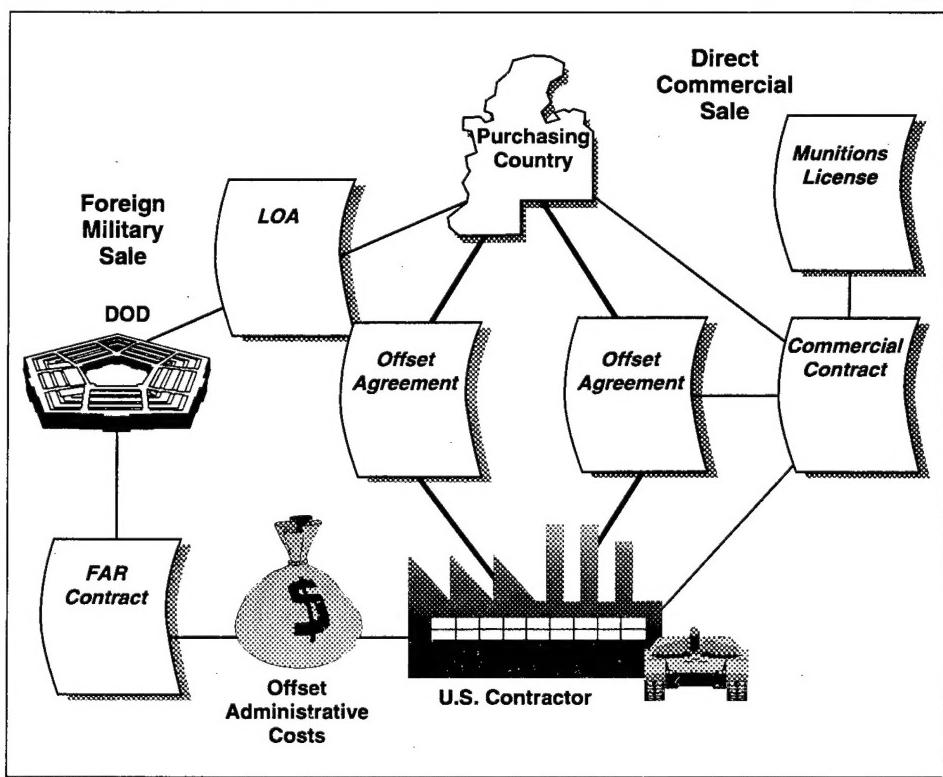
Military equipment is sold to foreign governments either by DOD through the FMS program or by defense contractors as direct commercial sales. These sales are accompanied by offset agreements that are established between U.S. defense contractors and purchasing governments. Although the U.S. government is a party to FMS agreements and issues licenses for technology transfers as needed, it is not a party to offset agreements and assumes no liability pursuant to the agreements.

In the past, contractors had to absorb the costs of offset implementation against their negotiated profit margins. In 1992, however, DOD recognized that contractors incurred such costs by allowing their recovery under FMS

¹Offset requirements are discussed in more detail in our 1996 report entitled Military Exports: Offset Demands Continue to Grow (GAO/NSIAD-96-65, Apr. 12, 1996).

contracts. Today, U.S. defense contractors may recover administrative costs incurred to implement their offset agreements under certain circumstances by charging such costs to the purchasing foreign government through the FMS contracts. Figure 1 illustrates the U.S. government's "hands-off" policy on offsets and the offset relationships between a U.S. contractor and a country purchasing FMS.²

Figure 1: Offset Relationships



Legend:

LOA - Letter of Offer and Acceptance
 FAR - Federal Acquisition Regulations

Source: The Management of Security Assistance, Defense Institute of Security Assistance Management, 17th Edition, May 1997, p. 303.

²FMS acquisition, offsets, and offset relationships are discussed in chapter 11 of the Defense Institute's Security Assistance Management, 17th Edition, May 1997.

Offset agreements ordinarily specify the level of offset required, normally expressed as a percentage of the sales contract, and the types of activities that are eligible for offset credits. Negotiating an offset credit is an important part of implementing offset agreements because countries can encourage companies to undertake highly desirable offset activities by granting additional offset credit through multipliers. For example, a country may grant an offset credit for advanced technology or training activities based on what the country would have paid to procure or develop the training or technology itself. Countries may also offer large multipliers to encourage desired activities.³

Wide Spectrum of Activities Contained in Offset Agreements

Offset agreements contain a wide spectrum of activities that U.S. contractors agree to undertake to satisfy their obligations. Offset agreements tend to be specific in stating requirements and ways they are to be satisfied. Offset activities can be grouped into the following categories: coproduction and subcontracting related to defense items, technology transfers, in-country procurements, marketing assistance, financial assistance, and investments or joint ventures. Activities can fall into more than one category. For example, coproduction activity may also include the transfer of technology needed to improve production processes. As another example, a contractor can buy carpet and display it prominently in its executive lobby—a combination of in-country procurement and marketing assistance activities. In addition, there are other activities that do not fit within any of these categories.

Coproduction and Subcontracting, Technology Transfers, and In-country Procurements Are Widely Used

Coproduction and Subcontracting

Coproduction tied directly to a weapons sale, subcontracting for defense-related products, and technology transferred as part of those arrangements, or separately, are transactions commonly found in the agreements we reviewed. Procurements of goods and services not related to the weapon system sales—indirect offset activities—were also frequently used.

Coproduction occurs when defense companies located in offset countries receive contracts to assemble, build, or produce articles for the weapon system sale. Subcontracting occurs when a U.S. contractor procures defense-related components and subsystems for export from suppliers in countries where the contractor has offset obligations. Foreign subcontracts are either competed within the purchasing country or

³A multiplier is used to increase the value of an offset project when determining offset credit. For example, if a company helped facilitate a \$10,000 export of a product with particular importance, the country could offer a multiplier of five, thereby increasing the amount of offset credit to \$50,000.

directed to an entity within that country. Regardless, per the agreements, U.S. contractors normally insist that the foreign companies meet certain contract standards for price, quality, and delivery to become qualified subcontractors. One U.S. contractor stated that foreign companies must meet the same contract standards as those used to select qualified U.S. subcontractors. Placing contracts overseas has resulted in additional contractors who are qualified to participate in weapon system development and production. However, the long-term supplier relationships that develop may result in reduced business opportunities for some U.S. firms. In the transactions we reviewed, coproduction and subcontracting activities ranged from 2.5 percent to 66.7 percent of the total offset obligation.

The following examples describe coproduction and subcontracting activities. A U.S. contractor used two foreign defense companies to assemble an aircraft and produce some of its components and parts. Together, the U.S. contractor and foreign country determined that these particular components and parts were compatible with the foreign companies' manufacturing processes and concluded they could be produced at a lower cost by the foreign companies than by the U.S. contractor.⁴ These activities equated to about 8.8 percent of the total offset obligation. According to the contractor, although the contractor did not solicit any U.S. companies to compete for the contract, it determined that the two foreign companies were competitive in their price, quality, and delivery. An Asian government, per the offset agreement, specified that it would select industry participants to manufacture airframe spares. This would allow all four of the Asian country's aerospace companies to participate and achieve a proportionate share of the spares manufacture.

U.S. contractors have established longer term relationships covering foreign firm participation in future sales of the weapon system and beyond their commitment in the purchasing country. In many cases, the foreign subcontractor will become a longer term supplier to the U.S. contractor for that item being produced. For example, an American defense contractor subcontracted a European defense company to assemble the tail section for a particular aircraft system sold worldwide. The manufacturing know-how was transferred to the company through a Department of State approved manufacturing license. In another illustration, a U.S. contractor subcontracted with a European company to manufacture test sets for a weapon system sold worldwide.

⁴We did not attempt to verify this conclusion because it was outside the scope of our review.

Technology Transfers

Technology transfer is widely used to fulfill offset obligations and often accompanies coproduction and subcontract activities. It, however, is also used in areas unrelated to defense procurements. From the contractors' perspective, technology transfers are often a relatively inexpensive way to earn offset credit because, in some cases, the contractors already possess the technology the foreign government desires. In most cases, the value of the technology transfer is negotiated between the U.S. contractor and the foreign government. The negotiated value of the technology is often based on the contractor's prior investment in research and development, the market value of the technology, or the cost to the foreign government for developing the technology itself. Multiples of the negotiated value are also used, depending on the value the foreign government places on certain types of technology. For example, in one European country, the multiplier for this activity varied between 1 and 20, depending on the benefits received by that country's industries. Recognizing the difficulty in determining the value of technology transfer, an Asian country and a U.S. contractor agreed to negotiate in good faith the mutually acceptable offset credit amount based on such factors as the market value, the license fees and royalties appropriate for such technology, the costs to transfer the technology, the sale or benefits resulting from the transfer, or the development costs of the technology.

Many of the purchasing countries prefer projects that require technology transfers because the transfers generally provide manufacturing skills and technical assistance that can be used to help the economic development within the countries. For example, a European government wanted to develop an in-country capability by using indigenous labor that would perform flightline and special repair activity maintenance. Thus, a U.S. defense contractor provided one of the country's defense companies a comprehensive technology transfer and training program that permitted the foreign company to train its country's Air Force personnel to operate, maintain, and repair a weapon system in accordance with appropriate U.S. military and manufacturer standards. The State Department permitted this technology to be transferred by approving the technical assistance and manufacturing license agreements between the two parties. The U.S. contractor received an offset credit when the training program was established, and it expects to earn future credit once the European company trains other countries with this technology. In another example, an Asian government, per the offset agreement, indicated a strong desire to infuse technology into the country's business in order to increase its commercial business capabilities. To satisfy this desire, a U.S. contractor

provided an Asian commercial company with technology and training in the area of commercial component manufacture.

In-country Procurements

In-country procurement is an indirect offset activity that entails purchases of goods and services not related to the foreign weapon system sale. In addition to the U.S. contractors making purchases, they also employ other parties such as major subcontractors, suppliers, and foreign entities to help meet their offset obligations. In a few cases, U.S. contractors advocated a foreign firm's product to DOD or suppliers. Suppliers will often purchase items from foreign countries in which a U.S. contractor has an offset obligation in an effort to strengthen relationships with the prime contractor or to establish new relationships with other customers that will eventually lead to future contracts. According to U.S. contractors, some of these items are purchased because of need and at competitive prices, others mainly to help satisfy an offset obligation.

Contractors often encourage their suppliers to participate in satisfying their offset obligations. For example, one U.S. defense contractor uses its supplier rating or performance evaluation system to encourage participation. The system measures factors such as the affordability, the quality, and the responsiveness (including offset cooperation as a subfactor) of the supplier and the supplier's goods. Depending on the overall rating, a supplier may receive an increased percentage of additional work from the contractor or recognition from other customers. Another contractor holds periodic conferences or places a clause within purchase orders as a means to inform suppliers of its offset obligations with foreign countries.

Our review indicated U.S. suppliers purchased items that included a recovery boiler, a batching system for producing float glass, satellite hardware, a pulsed laser deposition system, a pressurized filtration device, a turret punch press, a paper variability analyzer, an overhead crane system, transformer equipment, communications equipment, and ergonomic computer workstations. Foreign entities purchased 3-axle trailers, ferries, and automobile parts.

**Offset Transactions
Include Business
Development Activities**

U.S. contractors also undertook a wide variety of activities that could be labeled business development and are similar to those performed by an economic development ministry.

Marketing Assistance

Marketing assistance is defined as a U.S. contractor helping foreign companies penetrate and develop U.S. and/or non-U.S. markets by analyzing the market for the exporter's product or assisting the exporter in responding to a request for proposals. To help in this area, a U.S. contractor often pays brokers or consultants a fee to provide such services. For example, a U.S. defense contractor paid a U.S. broker to coordinate the transfer of oil and gas refining technology from a European oil company to an Indian oil company. The deal provided the opportunity for the European company to penetrate a new market. In another case, a U.S. contractor helped an Asian defense company that was performing modification work for the U.S. Air Force in that region. Similarly, a U.S. contractor paid a U.S. firm for helping a European company develop a competitive proposal for a U.S. military contract. One final example of marketing assistance involved a U.S. contractor funding a European organization's U.S. operations. The European organization promoted products in the United States, made by its country's small-sized, high technology businesses. The U.S. contractor received credit for the initial financial support, and it will receive credit for all future sales made to U.S. buyers by the small European companies.

Financial Assistance

Financial assistance is not as frequently used as others that we reviewed. Financial assistance is defined as providing funds to a foreign company in the country where the offset obligation exists to facilitate an export. Financial assistance can be in the form of incentive payments and success or service fees.⁵ For example, a U.S. defense contractor paid a foreign bank a service fee to provide financing assistance to a European shipbuilding company so it could manufacture container ships. The funds were used to complete the manufacturing of two vessels sold to a U.S. shipping company. Another example involved a European automotive parts manufacturer, a subsidiary of a U.S. automotive company, which acquired 100 percent of a foreign automotive component company that was going out of business. A U.S. defense contractor provided funds to the foreign company to help defray the acquisition cost. The U.S. contractor received an offset credit for assisting with the expenses. In another case, a contractor sponsored and underwrote a portion of the expenses for a European orchestra concert tour and industry export trade promotion show held in the United States.

Investments and Joint Ventures

Investments and joint ventures are occasionally used to satisfy offset obligations. An investment or joint venture occurs when a U.S. contractor

⁵In 1994, Congress passed the Feingold Amendment prohibiting incentive payments to induce U.S. persons or companies to purchase foreign goods or services to satisfy offset agreements (section 733 of P.L. 103-236). These transactions do not fall within the coverage of the Feingold Amendment.

serves as a facilitator to bring parties together, provides start-up costs to develop a new entity, or makes an equity investment in the foreign country. For example, a U.S. defense contractor and a European defense company negotiated a teaming agreement. Jointly, the team will develop an upgraded weapon system that will generate worldwide sales. The U.S. contractor, in turn, will receive an offset credit for its involvement in the venture. In another case, a U.S. contractor and a European software manufacturer established a joint development program to build software links between a systems integrator and the software architecture.

Other Activities

A few activities did not clearly fit into any of the other categories. For example, U.S. contractors may generate potential offset credits through activities that occur prior to contract award; a process called "banking". In one case, a successful contractor used banked offset credits to help satisfy its offset obligation. In another case, a successful contractor bought the unsuccessful contractor's banked offset credits.

Agency Comments

We requested comments on a draft of this report from the Departments of Defense, Commerce, and State and U.S. contractors. DOD and State officials responded that they did not have any comments. Commerce stated the details of the report complemented its legislatively mandated report on offsets (see app. I). The U.S. contractors did not provide written comments but generally agreed with our description of offset activities.

Scope and Methodology

To assess the activities undertaken by U.S. contractors to satisfy offset obligations, we analyzed over 100 transactions contained in 19 ongoing or recently completed offset programs by 6 major U.S. defense companies with 12 purchasing countries. We selected the countries based on their geographic locations and their purchases of foreign military equipment. The purchasing countries were Finland, France, Germany, Greece, Korea, Malaysia, Netherlands, Norway, Saudi Arabia, Switzerland, Turkey, and Taiwan. The defense companies were chosen based on their roles as prime contractors and subcontractors that provided offset services. The companies were Boeing, General Electric, Lockheed Martin, Northrop Grumman, Pratt & Whitney, and Raytheon.

We reviewed contractors' records for tracking offset activities and offset implementation costs charged to FMS contracts. We visited and interviewed company officials to obtain detailed data describing the offset activities. We examined supporting documentation for selected charges in order to

develop a description of offset activities undertaken for each program. We then summarized the activities by placing them into offset categories. The contractors reviewed and agreed with our definitions of the offset categories discussed previously. But, due to the proprietary nature of the offset agreements and programs, we were limited in our ability to present specific information on activities in these categories. In addition, we reviewed offset data reported to the Department of Commerce⁶ as well as foreign subcontracting data reported to DOD.⁷

We conducted our review from October 1997 to November 1998 in accordance with generally accepted government auditing standards.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

⁶Under the Defense Production Act amendments of 1992, 50 U.S.C. app. 2099, U.S. firms entering into contracts for the sale of defense articles or services to foreign countries or firms that are subject to offset agreements exceeding \$5 million in value are required to furnish certain information to the Department of Commerce regarding such agreements. Since 1995, U.S. firms have been required to report to the Bureau of Export Administration, on June 15 of each year, offset transactions that receive offset credits of \$250,000 or more claimed from a foreign country.

⁷A U.S. firm that is performing or is bidding on a DOD contract exceeding \$10 million is required by 10 U.S.C. 2410g to notify DOD if the firm or a first-tier subcontractor plans to perform more than \$500,000 of the contract outside the United States and Canada and the work could be performed inside the United States or Canada. DOD also administratively requires U.S. firms to submit a notification for contracts exceeding \$500,000, when any part that exceeds \$100,000 will be performed outside the United States.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report were Karen S. Zuckerstein, Lauri A. Kay, and Richard E. Burrell.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Katherine V. Schinasi". The signature is fluid and cursive, with "Katherine" on top and "V. Schinasi" below it.

Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues

Comments From the Department of Commerce



THE SECRETARY OF COMMERCE
Washington, D.C. 20230

NOV 25 1998

Mr. Louis J. Rodrigues
Director, Defense Acquisitions Issues
National Security and International Affairs Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Rodrigues:

Thank you for the opportunity to review your draft report on activities carried out by U.S. contractors in fulfillment of their offset obligations (GAO code 707306).

As you are aware, the Department of Commerce's Bureau of Export Administration prepares an annual report for Congress on offsets in defense trade. U.S. industry is required to provide the Department with data on annual offset agreements and transactions. The information in your study complements our analysis and provides an accurate snapshot of the steps that contractors take to meet their offset obligations.

Again, thank you for soliciting our views.

Sincerely,

William M. Daley